No. 12850

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

JOSEPH G. WHITE,

Appellant,

vs.

FRANCIS F. QUITTNER, Trustee in Bankruptcy of the Estate of Al Herd, Bankrupt,

Appellee.

APPELLEE'S BRIEF.

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APPELLEE'S BRIEF.

Preliminary Statement.

The appellant seeks a reversal of an order made by Referee Benno M. Brink, affirmed by District Judge Ben Harrison, adjudging that appellant has no valid claim in or to the sum of $6,220.00 in the possession of the trustee in bankruptcy (appellee). Said amount represents the proceeds paid by the appellant in satisfaction of a judgment against the appellant in an action at law brought in the Superior Court of Los Angeles County, by one George L. Gibbons against the appellant (hereinafter referred to as the "Gibbons action"), based on a promissory note executed and delivered by appellant to Gibbons dated May 19, 1947, in the principal amount of $5,000.00 [Tr. 389].

The said moneys came into the possession of the trustee by virtue of a written assignment (hereinafter called the "assignment") from Gibbons to the trustee, during the

pendency of the Gibbons action, whereby Gibbons assigned to the trustee *"any sums or proceeds recovered"** in said action [Tr. 323], in consideration of the trustee's release of all claims held by the trustee against Gibbons and of the trustee's dismissal with prejudice of a suit theretofore brought by the trustee against Gibbons (hereinafter described).

The proceeding below was initiated by an order to show cause (on the trustee's petition therefor) to quiet title to said funds in the trustee's possession [Tr. 3, 5]. An "amended answer" thereto was filed by appellant claiming he was entitled to said moneys [Tr. 7]. Issue was joined by the trustee's "reply" thereto setting forth a number of affirmative defenses to appellant's claim [Tr. 13], which need not be here detailed.

Appellant's position below was that he was at liberty to go behind said judgment in the Gibbons action and to reclaim in the proceeding before the referee the moneys paid by him in satisfaction of the judgment in the Gibbons action because, as the appellant claimed, the trustee did not tell him during the pendency of the Gibbons action that Gibbons had executed said assignment to the trustee. Appellant contended that by reason of the trustee's failure to advise him during the pendency of the Gibbons action of the said assignment by Gibbons to the trustee, he was denied an opportunity to set up an alleged defense or claim in bar, *i. e.,* that appellant executed and delivered the note to Gibbons as an accommodation to the *bankrupt.* Appellant contended that the trustee should return the proceeds because he can in no event stand in any better position than the alleged accommodated party, *i. e.,* the *bankrupt.*

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*Italics ours throughout, unless otherwise indicated.

That the trustee acquired the proceeds by virtue of an assigned interest from *Gibbons, after* bankruptcy, for a *valuable consideration* furnished by the *trustee,* was claimed by the appellant to be *immaterial.*

The referee examined appellant's claims *on the merits.* After a full trial, during which considerable oral and documentary evidence was introduced, the referee held that appellant did not have and never had any valid defense, claim, set-off or recoupment right as against the trustee, because the latter acquired his interest from *Gibbons* (rather than the bankrupt), *after* bankruptcy, for a valuable consideration furnished by the *trustee* [Tr. 37]. The district judge affirmed this ruling on review.

The appellant's entire brief is premised on the erroneous proposition that a trustee in bankruptcy can *not* acquire any right or interest independently of or superior to those of his bankrupt, even though the trustee may have acquired a right or interest by *assignment* from a *third party, after* bankruptcy, and for a *valuable* consideration. Although this is the heart of the case, the appellant's brief will be searched in vain for *any* case which deals with *this* question. The appellant has thus completely evaded the essential issues which this record presents.

The appellant's brief contains a number of misstatements. They will become apparent from our ensuing "Statement of the Case." However, a word might be said at this juncture about one of these misstatements. The appellant asserts that there was a "wrongful concealment" by the trustee of his interest in the action

brought by Gibbons against appellant (App. Op. Br. 13). This charge is completely insupportable. The referee has expressly found, and the district judge has affirmed the finding, that the trustee and his attorneys *"acted honestly and in good faith and in the diligent pursuit of the best interests of the bankrupt estate and its creditors"* [Tr. 36-37].*

Gibbons, the judgment creditor, was not a party to this proceeding.

Statement of the Case.

In our view, appellant's "Statement of the Case" is so distorted and incomplete that a full "Statement of the Case" by appellee should be of service to the court.

On May 19, 1947 (prior to the filing of the involuntary petition against the bankruptcy) appellant executed and delivered to Gibbons his promissory note in the sum of $5,000.00 to apply on the bankrupt's then existing indebtedness to Gibbons and to cause Gibbons to lift his attachment on the bankrupt's property [Tr. 35, 389]. At or about the same time appellant also executed and delivered a deed of trust note in the amount of $25,000.00 to the Morris Plan Company of California [Tr. 42] for the bankrupt's account, secured by a deed of trust on real property owned by appellant. The bankrupt thereupon gave appellant his own note for $30,000.00 [Tr. 389].

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*Every single step adopted by the trustee in respect to the assignment, his interest thereunder, and the substitution of the trustee's attorneys as attorneys for plaintiff in the *Gibbons* action, was undertaken pursuant to order of the bankruptcy court, upon written petition of the trustee, spread upon the records of the bankruptcy court. No mention is made of this fact anywhere in the appellant's opening brief.

The referee found that appellant executed the Gibbons note to accommodate the bankrupt [Tr. 35].*

On August 6, 1947, an involuntary petition was filed against the bankrupt [Tr. 42].

On December 24, 1947, the trustee filed an action in the United States District Court, Southern District of California, Central Division, against Gibbons to recover usurious payments claimed by the trustee to have been made by the bankrupt to Gibbons, and to set aside certain alleged preferential transfers by the bankrupt to Gibbons [Tr. 35-36].

The trustee caused a garnishment to be issued in said action which was served on appellant on April 13, 1948, as a debtor of Gibbons on the note executed by appellant to Gibbons [Tr. 36].

On May 3, 1948, the trustee filed a verified petition with the referee for leave to compromise the trustee's said suit against Gibbons then pending in the District Court. Said petition expressly disclosed the *full terms* of the settlement proposal of Gibbons, including in part Gibbons' offer to assign to the trustee either the note executed by the appellant to Gibbons, which was then the subject of a pending action brought by Gibbons against appellant, or in the alternative, to assign to the trustee the proceeds of any recovery by Gibbons therein.

Pursuant to said petition a notice of hearing was thereupon sent by the office of the referee to 134 persons, in-

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*The trustee's position was that, far from being an accommodation maker, appellant had an important business interest in executing the note in that he was given an interest in the bankrupt's used car business. The trustee's comprehensive and detailed offer of proof in this regard appears in the record [Tr. 229-240, 241-243].

cluding all listed or known creditors of the bankrupt, which notice was dated May 6, 1948 [Tr. 322]. Said notice sets forth, among other things, the full terms of the proposed compromise [Tr. 320-321], including the proposed alternative assignments to the trustee aforesaid. Said hearing was noticed for May 19, 1948.

On said date, *i. e.,* May 19, 1948, said petition to compromise the trustee's action against Gibbons came on for hearing and the petition was thereupon granted without opposition; and on May 25, 1948, an order was entered by the referee confirming and approving said compromise [Tr. 36, 38].

Pursuant to said order confirming the compromise, Gibbons executed an assignment to the trustee dated "June ....., 1948," which reads in part as follows [Tr. 323]:

> "KNOW YE that I, GEORGE L. GIBBONS, plaintiff in the [Gibbons] action, do hereby transfer, assign and set over unto [the trustee], all my right, title and interest in and to *any sums or proceeds recovered* in said action, whether by way of judgment, settlement or otherwise * * * and I do further covenant and agree that said action be continued in my name as plaintiff."

The trustee thereafter executed a general release to Gibbons and a dismissal with prejudice of the trustee's pending suit in the District Court against Gibbons [Tr. 38].

On June 16, 1948, the trustee filed his petition with the referee for an order authorizing Messrs. Wellins and Weber, the trustee's attorneys, to substitute themselves for Messrs. Jones and Wiener as attorneys for plaintiff

in the Gibbons action. Said petition, like the other documents herein referred to, was filed in the bankruptcy court, and reads in part as follows [Tr. 325]:

> "That in view of the fact that this estate is entitled to the *proceeds of any recovery* in said action, petitioner believes it to be in the best interests of this estate that his attorneys, Marvin Wellins and Daniel A. Weber, be substituted as attorneys for the plaintiff, George L. Gibbons, in said pending action against" [appellant].

An order was thereupon entered by the referee on June 16, 1948, authorizing said substitution of attorneys [Tr. 327-328].

On August 16, 1948, the Superior Court ruled that the answer filed by appellant in the Gibbons action was sham and frivolous and granted summary judgment on the note [Tr. 355-356].

Judgment was entered in favor of Gibbons and against appellant on August 25, 1948, and the judgment, plus accumulated execution costs, was satisfied by appellant's payment of the sum of $6,220.00 on December 14, 1948. Said payment was made in the form of two checks ($5,000.00 and $1,220.00). Upon delivery thereof, Mr. Wellins, co-counsel for the trustee, executed a receipt reading in part as follows [Tr. 328-329]:

> "THESE CHECKS have been delivered to me *as one of the Attorneys for* FRANCIS QUITTNER, *as Trustee in Bankruptcy of* AL HERD, *Bankrupt.* A receipt is acknowledged *on behalf of* FRANCIS QUITTNER, *as*

said Trustee, and as payment in full of the claim of GEORGE L. GIBBONS *against* JOSEPH WHITE, *et al.*, Case No. 533306, Los Angeles County Superior Court."*

No creditor's claim of any kind was ever filed by appellant in the bankruptcy proceedings. No appeal was ever

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*The appellant claimed ignorance of the trustee's interest in the Gibbons recovery despite this plain notice that the trustee was destined to receive these proceeds; and despite the fact that every single measure undertaken by the trustee in connection with the acquisition of the assignment to him, and of his interest in the Gibbons recovery, received the written approval of the referee upon written petition therefor; the fact that the bankruptcy court's files disclosed the full and complete facts; and despite other evidence which showed that appellant and his attorneys in the *Gibbons* action (who are also his attorneys in this appeal) negotiated with the trustee's attorneys with the aim of bringing about a dismissal of two then pending suits brought by the trustee against appellant, in consideration of the payment by appellant of the amount of the Gibbons note. The negotiations with the trustee's attorneys for a *joint settlement of three pending actions against appellant* were admitted by appellant's counsel.

Mr. Howard, co-counsel for appellant, testified on cross-examination as follows [Tr. 112-113]:

> "The Witness: Well, the tenor of the conversation was this, that we made an offer to pay the sum of $5,000.00 which would be *received by the Trustee in Bankruptcy;* that by virtue of his *attachment* [issued in the trustee's action against Gibbons] of Mr. White on the Gibbons note we would pay that sum, *the Trustee would get it,* and you, the attorneys for Mr. Gibbons and attorneys for the Trustee, would dismiss with prejudice the action of Quittner v. Rosen [a suit brought by the trustee against appellant and others for unlawful eviction of the bankrupt], as I recall, the action of Quittner v. White [a suit brought by the trustee against appellant for an accounting as an alleged partner of the bankrupt], and the Gibbons action.
>
> Q. By Mr. Wellins: Just so we tie it together, when you say Quittner v. Rosen, that was the unlawful eviction case, and the Quittner v. White was the partnership action, and the

taken by appellant from the judgment against him in the Gibbons action [Tr. 40, 41].

The referee expressly found that the interest of the trustee "under and by virtue of said assignment was acquired by the trustee in bankruptcy herein after the filing of the petition in bankruptcy" [Tr. 37]; and that the

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other was the promissory note action? A. The Gibbons action.

Q. The action between Gibbons and White? A. Yes. We made that offer, for which there was to be a dismissal with prejudice of *each of those actions.*" [Rep. Tr. p. 34, line 11, to p. 35, line 1.] (Words in brackets supplied.)

Mr. Horowitz, other co-counsel for appellant, also admitted on cross-examination as follows [Tr. 155-156]:

"Q. Isn't it fact that you knew at the time of the second conversation about which you have testified on your direct examination that Mr. Weber and I were speaking to you with a view toward the settlement of three pieces of litigation, the Gibbons suit and the two suits by the trustee against Joseph G. White? A. You see, at the time I had the conversation a summary judgment had not been granted. I wanted to settle that [Gibbons] suit and I said I would pay a certain sum in connection with that suit. I also—and that was in your capacity as attorney for Mr. Gibbons. I also told you at that time I would like and would want the other litigation [the trustee's two suits against the appellant] disposed of and as to the other litigation I didn't propose to pay anything, and never at any time did I offer to pay as much as one cent for the disposition of the other litigation. * * *." (Words in brackets supplied.)

Thus, both denied knowledge that the trustee had an interest in the Gibbons recovery, atlhough both admitted discussing with the trustee's attorneys a joint disposition of three actions, including the Gibbons action, premised upon appellant's payment of $5,000.00 (the amount of the Gibbons note). According to Mr. Howard, this was to be "received by the trustee * * * by virtue of his attachment" served on appellant as a debtor of Gibbons, issued in the trustee's suit against Gibbons. According to Mr. Horowitz, this sum was to be received by Mr. Wellins "as attorney for *Mr. Gibbons,*" for which Mr. Wellins was expected to deliver, as attorney for the *trustee,* dismissals with prejudice of two suits brought by the trustee against appellant, without payment to the trustee of "as much as one cent"!

trustee "acquired his interest thereunder for a valuable consideration furnished by the trustee" [Tr. 37].

The referee further expressly found as follows:

> "That on the date of the filing of the petition in bankruptcy in the above-entitled bankruptcy proceedings, to wit, August 6, 1947, said Gibbons was the owner and holder of said promissory note in the sum of $5,000.00 executed and delivered by [appellant] to Gibbons; and on said date the trustee in bankruptcy herein had no right, title or interest of any kind in or to said note, or the cause of action evidenced thereby, or the proceeds of any recovery thereon" [Tr. 42].

As a conclusion of law, the referee held:

> "The trustee's claims in and to said assignment and said proceeds are derived from Gibbons and not from the bankrupt" [Tr. 44].

The referee further concluded that appellant's claims against the bankrupt and the trustee's interest in the Gibbons recovery "do not involve mutual debts or mutual credits, nor can the matters asserted in the respondent's amended answer defeat the Trustee's interest under said assignment or his right to said proceeds" [Tr. 44].

The district judge concurred in the foregoing views and affirmed the referee's order quieting the trustee's title in and to the funds in his possession [Tr. 60-62].

Summary of Appellee's Argument.

Appellee contends that the judgment below is eminently proper for the following reasons:

1. The appellant was clearly liable on the note in the Gibbons action. This liability was in no wise affected by the trustee's "purchase" of the assignment of the proceeds from Gibbons. The continuation of the Gibbons action in the name of Gibbons as plaintiff was perfectly proper, and was expressly sanctioned by statute.

2. Even if the *trustee* had prosecuted the Gibbons action in his own name as plaintiff, appellant's claim that he executed the note for the accommodation of the *bankrupt* would have been as *untenable* against the trustee as it was against Gibbons. Since the trustee was the assignee of *Gibbons,* and since he acquired his interest *after* bankruptcy, for a valuable consideration, the trustee could enforce the note *even though the bankrupt could not.*

3. Appellant's alleged claim of recoupment was and is untenable because it is not "in the same right" as that asserted against him. The claims therefore are not "mutual."

POINT I.

The Appellant Was Clearly Liable on the Note in the Gibbons Action. This Liability Was in No Wise Affected by the Trustee's "Purchase" of the Assignment of the Proceeds From Gibbons. The Continuation of the Gibbons Action in the Name of Gibbons as Plaintiff, Was Perfectly Proper, and Was Expressly Sanctioned by Statute.

It is well settled that payee of an accommodation note, who furnishes consideration therefor, is entitled to enforce the same against an accommodation maker, even though the payee knows the note to be accommodation paper (Sec. 3110, California Civil Code; *People's Finance & Thirft Co. v. Moon,* 44 Cal. App. 2d 223.)

Gibbons was the payee of the note. As payee of the note he instituted action thereon against appellant prior to the petition in bankruptcy. Clearly the defense of accommodation maker was not maintainable against Gibbons, the payee thereof, who had furnished consideration for the note, *i. e.,* the lifting of his attachment on the bankrupt's property [Tr. 35].

Among the assets which passed to the trustee were a number of claims against Gibbons which the trustee sought to enforce in the trustee's action against Gibbons in the District Court. In settlement of the trustee's claim against Gibbons, and in consideration of the execution of a general release by the trustee to Gibbons and of the dismissal with prejudice of the trustee's action against Gibbons, Gibbons paid the trustee $3,000.00 in cash, and gave the

trustee a written assignment of "any sums or proceeds recovered" [Tr. 323] in the Gibbons action, and also agreed to withdraw a claim in the amount of $19,500.00 which Gibbons had filed in the bankruptcy proceedings [Tr. 387].

The referee thus correctly found on this undisputed evidence that the trustee acquired his interest in the note proceeds from *Gibbons—after* bankruptcy—for a *valuable consideration* [Tr. 37, 42, 44], *i. e.,* the compromise, settlement and release of the trustee's claims against Gibbons. In effect, the trustee purchased said assignment from Gibbons for that "price," and conversely, Gibbons "purchased" from the trustee his release from all claims and a dismissal of the trustee's action against him, by giving the trustee the assignment, together with $3,000.00 in cash, and a stipulation by Gibbons withdrawing his claim in the sum of $19,500.00 in the bankruptcy proceedings [Tr. 387].

The continuation of the promissory note action in the name of Gibbons, after the delivery of his assignment to the trustee, was expressly authorized and sanctioned under California law. Section 385 of the California Code of Civil Procedure provides that where a plaintiff in a pending action transfers all or any interest therein, "the action or proceeding may be continued in the name of the original party or the court may allow the person to whom the transfer is made to be substituted in the action or proceeding."

Under this section the transferee or assignee of a cause of action or of an interest in a pending action, even where he has acquired the plaintiff's *entire* interest,* has a right to continue the action in the original plaintiff's name and to control the future conduct of the action even though the same be conducted in the name of the original plaintiff.

Cully v. Cochran, 107 Cal. App. 525, 529;

Harlan Douglas Co. v. Moncur, 19 Cal. App. 177, 179;

Walker v. Felt, 54 Cal. 386, 387.

It is therefore clear that the continuation of the action in Gibbons' name *was expressly sanctioned by California law.* Nor was the validity or enforceability of Gibbons' cause of action on the note affected by the trustee's "purchase" of the assignment from Gibbons after bankruptcy, for a valuable consideration.

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*The instant assignment gave the trustee an interest in the *proceeds* recovered, rather than *title* to the note or cause of action thereon. In our view, it would make no difference in the determination of this case, whether the assignment in terms covered complete title to the note and cause of action.

POINT II.

Even If the Trustee Had Prosecuted the Gibbons Action in His Own Name as Plaintiff, Appellant's Claim That He Executed the Note for the Accommodation of the Bankrupt Would Have Been as Untenable Against the Trustee as It Was Against Gibbons. Since the Trustee Was the Assignee of Gibbons, and Since He Acquired His Interest After Bankruptcy, for a Valuable Consideration, the Trustee Could Enforce the Note Even Though the Bankrupt Could Not.

A trustee in bankruptcy stands in a dual position. To be sure, he possesses certain rights as the representative of the bankrupt. However, the trustee's powers go much further. The trustee "primarily represents the creditors themselves, and in a secondary and restricted sense the bankrupt as well" (4 *Collier on Bankruptcy,* p. 945). The dual status of the trustee arises from the provisions of the Bankruptcy Act (see Secs. 60, 67 and 70 of the Bankruptcy Act).

> "The trustee represents the general creditors and in this capacity may assert claims, avoid preferences and collect assets *where the bankrupt, if bankruptcy had not intervened, would be estopped.*" (*In re Gustav Schaeffer Co.* (C. C. A. 6), 103 F. 2d 237, 241; cert. den. 308 U. S. 579.)

In *Collier on Bankruptcy* the rule is thus stated:

> "It is quite apparent, therefore, that the (Bankruptcy) Act confers certain rights and powers on the trustee *over and above those accorded the bankrupt and in some cases, the bankrupt's creditors.*" (4 *Collier on Bankruptcy,* p. 950.)

To the same effect see:

In re Kessler, 186 Fed. 127, 130;

Merchants Nat. Bank v. Sexton, 228 U. S. 634, 644, 33 S. Ct. 725;

Schroeter v. Abbott, 185 Cal. 146, 149-150;

4 *Collier on Bankruptcy,* page 945;

In re Hargrove, 64 Fed. Supp. 103, 106.

In *Schroeter v. Abbott,* 185 Cal. 146, the court stated (pp. 149-150):

> "Creditors' rights which are enforceable under State laws accrue to a trustee in bankruptcy, and he may maintain or defend proceedings and collect assets under circumstances where the bankrupt could not be at liberty to act. (*Courtney v. Fidelity Trust Co.,* 219 Fed. 57 . . .' *In re Kessler, supra; In re De Novess Shoe Co.,* 210 Fed. 533.) In other words, while the trustee must resort to the courts of the State where the bankrupt resides, he may therein enforce rights and avail himself of remedies which are open to him as a representative of the creditors of the corporation which might *not* be available to the corporation itself. (*Bardes v. Howardan Bank,* 178 U. S. 524 . . .; *Hicks v. Knost,* 178 U. S. 541 . . .)"

Also, the trustee frequently gets title where the bankrupt had *none.*

> ". . . the trustee does not always occupy merely the status of the bankrupt, but frequently may get a better title than the bankrupt had, or, in some cases, get title where the bankrupt had none." (*In re Monticello v. Veneer Co.,* 2 Fed. Supp. 27, 28.)

Thus, the trustee may avoid preferential transfers although the bankrupt could not (Sec. 60, *Bankruptcy Act*).

The trustee may assert either the rights of a lien creditor or of a judgment creditor although neither the bankrupt nor any creditor individually could have exercised such powers (Sec. 70c, *Bankruptcy Act*).

The trustee may avoid liens obtained against the bankrupt's property by legal or equitable proceedings within four months of bankruptcy, although neither the bankrupt nor any creditor would have such power (Sec. 67a, *Bankruptcy Act;* 4 *Collier on Bankruptcy,* pp. 949, 950).

In addition, the trustee may *in his own right* operate a business for the benefit of the estate, or *buy or sell* property in the interests of the estate, and thereby become a creditor *in his own right* and enforce a liability incurred to him without being subjected to payment of any indebtedness, set-off or counterclaim against the bankrupt arising *before* the filing of the petition (4 *Collier on Bankruptcy,* p. 743).

> ". . . claims owed by or to the bankrupt prior to bankruptcy cannot be set off against claims owed by or to the bankrupt's estate (as represented by the receiver or trustee) and arising after bankruptcy." (4 *Collier on Bankruptcy,* p. 473.)

It is firmly established that *the date of the filing of the petition in bankruptcy* is the date of "cleavage," and is the point of reference in determining the right of recoupment against a trustee. Where, as in this case, the rights of the trustee arose *after* bankruptcy, by dint of a contract which the trustee entered into, and the claim sought to be recouped against the trustee arose *before* the filing of the petition, no recoupment can be allowed.

In the case of *White v. Stump,* 266 U. S. 310, the Supreme Court stated the rule as follows (p. 313):

> ". . . the point of time which is to separate the old situation from the new in the bankrupt's affairs is *the date when the petition is filed.* This has been recognized in our decisions. Thus, we have said that the law discloses a purpose 'to fix the line of cleavage' with special respect to the conditions existing *when the petition is filed.*"

See also:

> *Lockhart v. Garden City Bank & Trust Co.,* 116 F. 2d 658, 661.

It is always necessary to determine, with due regard for "the line of cleavage," whether the trustee is making a claim *in his own right* or in the right of the *bankrupt.* The case of *In re Kessler,* 186 Fed. 127, is instructive on this point. The court said (p. 130):

> "The proper inquiry is *in what right* is any given claim advanced? If it is the bankrupt's claim, then truly the trustee must stand in the bankrupt's shoes; *but if it is his own claim, depending on his own acts created by himself,* or by the statute he does *not* represent the bankrupt, and his rights are not to be measured by those of the bankrupt."

A case directly in point is *Merchants Nat. Bank v. Sexton,* 228 U. S. 634, 33 S. Ct. 725. In that case a trustee in bankruptcy paid out of estate assets in his hands the sum of $12,000.00 to the holders of certain collateral notes aggregating the sum of $39,000.00. The sum of $12,000.00 represented the amount due upon the indebtedness which the collateral notes were given to secure. Upon making such payment of $12,000.00 the trustee received the collateral notes.

The court held that the trustee could enforce the collateral notes *even though the bankrupt would not have been allowed to do so.* The court pointed out (33 S. Ct. at p. 728):

> "By the effect of the bankruptcy the rights of the parties became fixed."

There too it was urged that since the bankrupt could not have enforced the collateral notes, the trustee should likewise be precluded from enforcing them. The court answered that if such a contention were upheld, "the situation existing at the time of the adjudication would be seriously changed" (p. 729), and concluded that since the trustee had acquired the collateral notes *after* bankruptcy, he had the right to enforce them even though the bankrupt would not have been permitted to do so (p. 729).

These established bankruptcy principles are controlling here, as the referee and district judge have held. When the petition in bankruptcy was filed, the bankrupt had no title or interest in the note (or its proceeds). *Gibbons owned and held it.* After bankruptcy the trustee acquired his interest in the proceeds of the note—an interest "depending on his (the trustee's) *own acts* created by himself" (*cf. Kessler* case, *supra*), to-wit, his making of a contract with Gibbons to take the assigned interest in the note proceeds, plus $3,000.00 in cash, plus a withdrawal of Gibbons' claim in bankruptcy, in consideration of the trustee's delivery of a general release to Gibbons and a dismissal with prejudice of the trustee's action against Gibbons. No interest in the note or proceeds devolved upon the trustee until he acquired, with the approval of the bankruptcy court, the assignment of the proceeds by way of compromise with Gibbons.

If appellant had any defense or right of recoupment *against Gibbons,* such a claim might have been good against the trustee. But appellant admittedly has no claim against Gibbons. Gibbons could have recovered on the note and given the proceeds of recovery to anybody he wished. Similarly, he and the trustee were at full liberty to enter into a contract requiring Gibbons to pay such proceeds to the trustee as part of the settlement between the trustee and Gibbons.

POINT III.

Appellant's Alleged Claim of Recoupment Was and Is Untenable Because It Is Not "in the Same Right" as That Asserted Against Him. The Claims Therefore Are Not "Mutual."

Although appellant argued below that he had a valid right of set-off as well as recoupment against the trustee, he has apparently completely abandoned his claim to a "set-off." Such a claim would have to comply with all of the requirements of Section 68 of the Bankruptcy Act.

By styling his claim one of "recoupment" appellant can not exempt himself from the requirement of "mutuality" —a prerequisite to *recoupment as well as set-off.*

The Bankruptcy Act, as such, does not use the word recoupment; nor does it have any particular sections expressly giving rights by way of "recoupment." Similarly, the California statutes do not have any reference to the word "recoupment."

> "As used in the California Codes, 'counterclaim' possesses a generic meaning and includes . . . set-off and *recoupment* . . ." (23 *Cal. Jur.* 217; citing *St. Louis National Bank v. Gay,* 101 Cal. 286, and *Roberts v. Donovan,* 70 Cal. 108.)

Under Section 438, California Code of Civil Procedure, a counterclaim can only exist in favor of a defendant and against the plaintiff between whom a several judgment might be had in the action.

Under California law "the right to plead a counterclaim or a set-off must be *reciprocal,* and the claims *mutual*" (23 Cal. Jur. 220; citing *Story, etc., Company v. Story,* 100 Cal. 30, and *Lyon v. Petty,* 65 Cal. 222.)

The federal cases with respect to the requirements of recoupment accord with the California decisions. Several of the federal cases decided under the Bankruptcy Act speak in terms of "counterclaim" and "set-off," and use these terms generically to include the concept of recoupment. They deny recoupment wherever the requirements of mutuality are not satisfied, *i. e.,* claims in the same right, and claims co-existing prior to the filing of the petition in bankruptcy. While it is true that the provisions of Section 68 of the Bankruptcy Act (relating to set-off) do not govern claims which are strictly denominated "recoupment," the element of *mutuality* is nevertheless a prerequisite to such a claim because of its very nature.

The following cases are illustrative of the meaning of "mutuality":

In the case of *Bennett v. Rodman & English,* 2 Fed. Supp. 355 (affirmed as *Bennett v. Louis Bossert & Sons, Inc.,* 62 F. 2d 1064), the trustee sued to recover (as a fraudulent transfer) money paid by the bankrupt while insolvent to the defendant on account of debts owing to the defendant. The defendant sought to set-off a debt owed to him by the bankrupt. This set-off was denied on the ground that the debts were not mutual.

In *United States v. Roth,* 164 F. 2d 575, the court said: "To be mutual the debts or credits 'must be in the same right'" (citing *Sawyer v. Hoge,* 17 Wall. 610, 622; *In re Bush Terminal Co.,* 93 F. 2d 661; *In re Hood v. Brownlee, supra;* 4 *Collier Bankruptcy* (14th Ed.) 721). The court held that where a trustee asserts a right conferred upon him for the benefit of creditors under Section 67 of the Bankruptcy Act, rather than as successor in interest of rights of the bankrupt, one cannot off-set a claim owed by the bankrupt. The court said:

> "The tax claim asserted by the United States was owed by the bankrupt while the debt it owes * * * is owed to the trustee and was never owed to the bankrupt. Hence the required mutuality of debts is lacking."

In *Hood v. Brownlee,* 62 F. 2d 675, a bank was held not entitled to set-off a debt of the bankrupt against a deposit of the trustee, for the reason that the debt due from the bankrupt to the bank and the debt owing from the bank to the trustee on account of the trustee's deposit were not mutual debts or credits.

> "They were not owing by and to the bank 'in the same right.' The claim of the bank arose out of the individual debt of the bankrupt, and the only liability of the trustee with respect thereto was to apply upon it a portion of the assets of the bankrupt estate under the order of the court of bankruptcy. The liability of the bank on the deposit made by the trustee was to the trustee as representative not of the bank alone, but also of the creditors of the bankrupt estate."

In *Alvord v. Ryan,* 212 Fed. 85, it was held that in a suit by a trustee to recover property transferred by the bankrupt to one who held it subject to a trust, there could be no set-off of a debt due from the bankrupt since these claims were not "in the same right."

Similarly it has been held that there is no mutuality where a claim for services rendered to the bankrupt was asserted as a set-off against the claim of a trustee for recovery of a fraudulent transfer, the claims not being in the same right. (*Irving Trust Co. v. Frimmitt,* 1 Fed. Supp. 16; *Lytle v. Andrews,* 34 F. 2d 252.)

The case of *In re Bush Terminal Co.,* 93 F. 2d 661, involved a claim of a taxpayer for taxes paid to the city under protest *after* institution of proceedings for recovery of a tax. The court held that such a claim was not "mutual" with a claim of the city for taxes due from the taxpayer *prior* to institution of such proceedings and could not be set-off. The court said:

> "A credit in the trustee arising out of the activities carried on after adjudication has no element of mutuality with a debt owing by the bankrupt to a person with whom the trustee has been doing business."

In *Kaye v. Metz,* 186 Cal. 42, the requirement of *mutuality* was also emphasized. In that case a trustee in bankruptcy of a corporation sued to recover unpaid stock subscriptions. The defendant subscribers sought to interpose as a defense claims which they had as creditors of the corporation. The court denied them the right to assert such claims on the ground of lack of mutuality. The court said (p. 49):

> "In order to warrant a set-off 'the debts must be mutual, and the principle of mutuality requires that

the debts should not only be due to and from the same person, but in the same capacity.' 19 Cyc. 894.

"The trustee in bankruptcy held these stock liabilities, as above stated, as a trust fund for the benefit of creditors. They were not held by him in the same capacity as would be the case if the corporation was not insolvent and had in itself sued the stockholder for his subscription; hence, a set-off is not permitted."

The language of the court in the case of *Schroeter v. Abbott,* 185 Cal. 146, is also helpful in demonstrating the similarity of interpretation between California law and federal law in respect to mutuality. In that case the court said as follows (p. 149):

"The trustee is not representing the bankrupt corporation in collecting these unpaid subscriptions, but is representing the creditors. (*In re V. & M. Lumber Co.,* 182 F. 231; *In re Kessler,* 186 F. 127 . . .; *Babbitt v. Read,* 215 F. 395.)"

See also:

H. K. McCann Company v. Week, 115 Cal. App. 393;

McDaniel National Bank v. Bridwell, 74 F. 2d 331, 333;

Peterson v. Lyders, 139 Cal. App. 303, 306;

Garrison v. Edward Brown & Sons, 25 Cal. 2d 473, 477;

Libby v. Hopkins, 104 U. S. 303;

In re Shults, 132 Fed. 573;
Dakin v. Bayley, 290 U. S. 143;
In re Bevins, 165 Fed. 434;
Maryland Casualty Co. v. Parker, 279 Fed. 796.

Thus, one who is sued by a trustee in bankruptcy and attempts either to defeat the trustee's claim, or to diminish it, or to recover affirmatively against the trustee—by way of set-off, counterclaim or recoupment—must in every case meet the requirements of *mutuality, i. e.,* the claims must be derived in the same right and they must have been in existence prior to filing the petition in bankruptcy.

In the case at bar, appellant's claim of recoupment is lacking in mutuality because the debt which was the subject of the Gibbons action was a note from appellant to Gibbons. *This is not a situation where appellant's debt was owed to the estate of the bankrupt and the estate owed a debt to appellant.* It was the obligation owed to Gibbons that was collected from appellant.

Mutuality is lacking for the reason that the trustee, having purchased the right to receive the proceeds of the Gibbons' note, received the funds "in the right of" Gibbons. The trustee was not proceeding to collect an account which was owed by the bankrupt at the time of bankruptcy. He was not proceeding "in the right of" the bankrupt. The claim asserted by appellant is a claim which could exist only against the bankrupt (under certain conditions), and not the trustee.

Appellant's Cases Are Completely Inapplicable.

In the case of *Howard Johnson v. Tucker,* 157 F. 2d 959, cited by appellant, the facts are completely at variance with those in the instant case. In that case the trustee was seeking to enforce *a contractual cause of action which the bankrupt held at and prior to the time of filing of the petition in bankruptcy.* In the case at bar, the bankrupt had no cause of action, or title to the note, or right to enforce the note before bankruptcy or at any other time. In that case the trustee did *not* acquire his cause of action after bankruptcy, whereas in the instant case the trustee acquired his interest in the proceeds of the Gibbons note *after* bankruptcy, in pursuance of his duties on behalf of the creditors of the bankrupt estate.

The case of *Stern v. Sunset Road Oil Co.,* 47 Cal. App. 334, cited by appellant, is also not in point. In the *Stern* case plaintiff was an assignee of a railroad company which had a contract with Sunset, the defendant. The contract was partly performed before and partly after notice of the assignment. The court held that it was one entire contract and was not divisible with respect to the part performed before the notice of assignment and that performed after notice of assignment. The court held the contract to be an "entire" contract. Accordingly, Sunset was permitted to assert defenses arising out of alleged breaches of the contract by the railroad company. The facts there involved do not remotely parallel the situation in the case at bar. Here the plaintiff's assignor was Gibbons. Appellant does not seek to assert defenses against *Gibbons,* because appellant admits, and the Superior Court has adjudged, that appellant had no defenses against Gibbons.

Nothing in the *Stern* case alters the rules of recoupment requiring that the claims be mutual, and requiring that the claims which are the subject of recoupment be "in the same right" as those which are the subject of the plaintiff's cause of action. The *Stern* case is merely an illustration of the rule that an assignee stands in the shoes of his *assignor,* and that where there is an "entire" contract performed in part after the assignment thereof, defenses arising out of a failure of such performance are available to the party sued on such contract.

The proposition contended for by appellant that where the accommodated party acquires the note which was executed for his accommodation, *his transferee* may not enforce the note, adds nothing to the case. However correct this may be as a statement of the law, it is enough to say that the trustee did *not* acquire this note from the bankrupt *nor had the bankrupt ever acquired the note.* The note remained in Gibbons' hands as payee until the trustee acquired it from Gibbons after bankruptcy for a valuable consideration. Thus the note was *never* acquired by the accommodated party, *i. e.,* the bankrupt.

Furthermore, the trustee was certainly under no obligation to use estate assets to purchase or acquire the note from Gibbons, the payee, in order to thus "buy off" appellant's liability on the note and afford appellant complete exoneration. Such use of bankruptcy assets, *i. e.,* in the sole interest of appellant, would represent a use of estate assets of the most preferential and wrongful nature. Appellant would thus be the sole recipient or beneficiary of the trustee's use of estate assets.

The case of *Bosworth v. Cady,* 72 F. 2d 62, was a case involving the receiver of a bank for whose accommodation a note was executed. It was held that the receiver, having received the note directly from the accommodated party, *i. e.,* the bank, took the note subject to whatever defenses were available against it. This situation is hardly comparable to a purchase made by a trustee with bankrupt estate assets after bankruptcy, not from the accommodated party, but from the payee who gave value. In the *Bosworth* case the receiver was suing in the right of the bank from whom it acquired title and not in the right of a third party who paid value for the note.

The case of *Bank of America v. Pac. Ready Cut Homes,* 122 Cal. App. 554, cited by appellant, simply holds that a right of recoupment assertible against an assignor may be asserted *against his assignee.* The trustee's assignor here was *Gibbons,* against whom appellant *had no claim.* We do not dispute that if the trustee had acquired the note from the *bankrupt* before bankruptcy, the trustee would not stand in any better position than the bankrupt.

In the case of *In re Monongahela Rye Liquors,* 141 F. 2d 864, the trustee sought to enforce claims for liquor sold by the *bankrupts* before bankruptcy, in a proceeding brought by the Commonwealth of Pennsylvania to enforce payment of taxes owed by the bankrupt. Obviously such a case is of no aid where the trustee's right stems from his acquisition of an assignment, not from the bankrupt but from a third party after bankruptcy.

Conclusion.

The trustee did *not* acquire the note or proceeds, or any interest therein, from the bankrupt. The bankrupt never had any interest in the note which devolved upon the trustee. In receiving the proceeds, the trustee was *not* acting in the right of the bankrupt. The trustee *purchased* his interest in the proceeds by his own contract with Gibbons after bankruptcy. The appellant concededly had no defense to Gibbons' claim on the note (as the Superior Court adjudged).

The appellant was given his day in court and after a hearing on the merits, the referee determined that he did not have, and never did have, any defense, set-off or recoupment right as against Gibbons or the trustee, and that none could have been maintained in the Gibbons action or in the bankruptcy court. The district judge was in accord with the referee.

In view of the demonstrable lack of merit in the appellant's claim, and of the correctness of the referee's determination as well as that of the district judge, adjudging that on the merits the appellant's claim was not one which was maintainable, or could have been maintained, against Gibbons or the trustee, either in the Gibbons action or in the bankruptcy court, we believe no useful purpose would be served in discussing in this brief the other bars to the appellant's claim asserted in the trustee's pleading [Tr. 13-32].

Respectfully submitted,

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